COASTAL PROPERTY INSURANCE ISSUES IN SOUTH CAROLINA

A REPORT OF THE
SOUTH CAROLINA DEPARTMENT OF INSURANCE

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REPORT SCOPE AND METHODOLOGY

This report addresses the availability and affordability of property insurance coverage in South Carolina's eight coastal counties. The South Carolina Department of Insurance ("Department") surveyed insurers licensed to sell property and casualty insurance products in those counties. Insurers submitted detailed exposure and premium data, sorted by zip code, for years 2001 through 2005. The Department obtained similar data from the South Carolina Wind and Hail Underwriting Association ("the Wind Pool"). Additionally, the Department interviewed representatives of the top three firms placing business within the surplus lines market.

Department staff examined numerous sources including literature regarding coastal property insurance issues, a June 2006 survey conducted by the Independent Insurance Agents and Brokers of South Carolina on coastal property market conditions, and homeowners premium and exposure data compiled by the National Association of Insurance Commissioners ("NAIC"). Department staff also interviewed and received data from representatives of coastal realtor associations, the state's home builders association, regional councils of government, the Wind Pool, and county planning departments.

The impact of this issue is most immediately and acutely felt by consumers. The Department has received hundreds of consumer inquiries and complaints concerning coastal property insurance, and has responded to every consumer and attempted to address concerns within the confines of the Department's authority and ability. For direct consumer input on coastal property insurance issues, Director Eleanor Kitzman addressed public forums in Horry, Georgetown, Charleston and Beaufort Counties. The Director and members of her staff have met with legislators from the coastal counties to discuss coastal property insurance issues and their impact on consumers. The Director has worked closely with the NAIC and her counterparts in other coastal states to explore options for resolving the problem of coastal property insurance availability that exists in many states. The Director appeared with the NAIC and Florida Insurance Commissioner Kevin M. McCarty before a hearing on coastal insurance issues of a subcommittee of the United States House of Representatives Capital Markets and Insurance Committee in Washington, D.C. Director Kitzman met with representatives of the American Association of Retired Persons ("AARP") because of the disproportionate impact of this issue on condominium owners, many of whom are retirees. Director Kitzman has also met with numerous coastal insurers (both admitted and surplus lines), and with reinsurers based in Bermuda and London, which provide over 90 percent of the catastrophe reinsurance for South Carolina, in an attempt to better understand the causes of the current problem and to recruit new carriers to the state.

REPORT LIMITATIONS

This report represents the best efforts of the Department and was prepared from the best information available. Numerous sources provided data and other information for this report, including county planning departments, regional councils of government, members of the insurance industry, state and federal agencies, and consumers. Various methods may have been used by those sources to collect the data provided to the Department, and no independent verification of that information or methodology was done. Some of the information discussed herein is based on anecdotal reports from insurance agents and brokers, coastal residents and other interested parties. To date, there have been no ongoing, long-term, empirical studies conducted on South Carolina coastal property insurance issues.

EXECUTIVE SUMMARY

The South Carolina coast has experienced dramatic growth in the last fifteen years. This growth brings jobs, adds new industries, enhances educational opportunities and increases tax revenues. Quite simply, this growth creates economic prosperity. Private insurance has facilitated unprecedented economic expansion in this country generally, and in South Carolina in particular. A healthy insurance marketplace is vital to the continued success of our state's economy.

From Texas to Maine, coastal property insurance premiums are increasing and coverage is decreasing as fewer insurers are selling fewer policies or are pulling out of coastal property insurance markets altogether. South Carolina's coastal property insurance marketplace is confronted both with skyrocketing insurance costs and limited choices for consumers.[1] The current state of coastal property insurance threatens to derail the improving economic climate of the entire state, not just the coastal areas. While coastal residents and businesses are most immediately and severely impacted by this issue, it has statewide ramifications. The entire state of South Carolina derives tremendous economic benefit from the coast, and not just from tourism, as evidenced by, among many examples, the BMW plant in the Upstate, which would not exist without the port of Charleston.

Significant catastrophe losses by the insurance industry in recent years, forecasts for above-average hurricane frequency and severity, increased costs of reinsurance, increased property values, rising construction costs, and concerns about financial rating downgrades are some of the factors contributing to the declining availability and increasing cost of coastal property insurance in South Carolina. In light of meteorological predictions of continued increased storm frequency and severity, the issue is not if, but when and how often, South Carolina will be directly impacted by hurricanes.

[1] In stark contrast, the property insurance market in the rest of the state is thriving. Rates are at all-time lows as a result of a competitive marketplace due, in large part, to the absence of significant risk of catastrophic loss.

Moreover, and more pertinent to this report, the question is: What is the least expensive, most efficient way to cover the cost of the inevitable? Additionally, should coastal residents bear these costs alone or should all citizens participate on some basis? Finally, should these costs be paid with private sector capital or financed by taxpayers as public debt?

Addressing these challenges will take a combination of both short-term and long-term initiatives, involving significant public policy decisions. Options for consideration include:

1. Loss mitigation initiatives, including development of a standardized wind resistance rating system, retrofitting of existing properties to improve wind resistance, incentives to encourage loss mitigation, and support for and enforcement of strong building codes.

2. Residual Market reform, including clarification of the purpose of the Wind Pool, redefinition of the territory, changes to the Director's authority to respond to dysfunctional market conditions, quarterly reviews to ensure that rates are actuarially sound and self-sustaining, and conversion to tax-exempt status.

3. Creation of a state hurricane catastrophe reinsurance fund to provide a stable and ongoing source of additional insurance capacity that is not being provided by the private sector.

4. Insurance reforms, including discounts based on storm resistance rating, notification of available discounts, non-wind policies, policies for the amount of the mortgage only, higher deductible options and more notice of cancellation or non-renewal than the current 30 days. Prohibitions against insurer "cherry-picking" have also been put forward and include requiring insurers to write in all parts of the state and that they write property insurance in South Carolina if they

write any other line of business in South Carolina and write property insurance in other states.

5. Advocating changes in Federal tax laws to allow insurers to build tax-deferred catastrophe reserves that would reduce premiums paid by consumers, and to create catastrophe savings accounts, much like health savings accounts, that would allow consumers to contribute to pre-tax dollars that could be used for loss mitigation, hurricane deductibles and other catastrophe-related expenses.

6. Formation of a capital incentive program for insurers to create additional coastal property insurance capacity.

7. Funding the Department’s catastrophe modeling evaluation process.

8. Adoption of post-event emergency procedures to expedite claims payment and provide certainty to both consumers and insurers of their rights and responsibilities after a catastrophic event, and authorization of emergency powers to the Director.

SOUTH CAROLINA'S COASTAL PROPERTY INSURANCE MARKET

INTRODUCTION

The market for property insurance in the coastal areas of South Carolina consists of three types of insurers: admitted (sometimes referred to as "voluntary"), surplus lines (sometimes referred to as "non-admitted") and residual (sometimes referred to as "involuntary").

Additionally, there are three important underlying concepts that apply to these insurers and to their relationships to each other and to the coastal property insurance market generally:

CAPACITY

Insurance capacity is the maximum amount of risk an insurance company can underwrite based on its financial condition. Insurers must have a certain amount of capital to support each policy they write. The more risky the nature of the policies written, the more capital that is required. Less risky business requires less capital and means insurers can write more policies.[2] The 2004 and 2005 hurricane seasons have caused a reduction in capacity in U.S. coastal property insurance markets. As a result of the reduction in capacity, insurance companies are enforcing stricter underwriting standards to limit their exposure in certain high risk areas, limiting the types of properties they select to insure, or insuring fewer or less expensive properties. Insurers are also increasing policyholder deductibles or percentage deductibles for certain "named storms," hurricanes, and water or wind damage.[3]

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[2] See discussion concerning rating agencies at page 19.

[3] Percentage deductibles are based on the home's insured value. If a house is insured for $100,000 and has a 2% deductible, the first $2,000 (or 2% of $100,000) of a claim must be paid out of the policyholder's pocket.

AVAILABILITY

Availability refers to the supply of insurance, or the amount of insurance available for purchase, relative to the demand for insurance, or the number and value of properties that need to be insured. Fewer insurers writing policies, or the same number of insurers writing fewer policies, may result in a lack of availability even if there is no increase in the number of policies or amount of insurance needed by consumers. Likewise, an increase in the number of policies needed (due to increased development) or amount of insurance needed (due to increased property values), may result in a lack of availability even if the same number of insurers are writing the same number of policies or amount of insurance. A combination of these two scenarios typically results in both limited availability and increased prices, as has occurred in South Carolina. Availability is not constant and can be intermittent in a distressed market. As carriers continually evaluate their exposure, availability can vary from day to day, resulting in uncertainty and instability for consumers, businesses and the economy, which need predictability.

AFFORDABILITY

Affordability is perhaps the most subjective of the three concepts. South Carolina law requires the Department to ensure that rates charged by insurers are not inadequate, excessive or unfairly discriminatory. The Department must also ensure that rates 1) are commensurate with the risk and 2) allow the insurer to meet its policyholder obligations (i.e. pay claims in the event of a loss).[4] Additionally, insurers are allowed to earn a reasonable profit on each line of business they write.[5] Understandably, everyone wants a lower rate, but it must be an adequate rate to ensure payment of claims, particularly in the event of a major storm when private insurance funds the rebuilding process.

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[4] Solvency surveillance, including claims-paying ability, is the most important function of the Department and represents the highest form of consumer protection.

[5] "Reasonableness" is a function of the riskiness of the line of business and the profit that could be earned by the insurer if it invested its capital elsewhere. Excess profits laws prevent insurers from earning "too much," but apply on a state by state basis and by line of business, over a 5 year period of time. (*See* S.C. Code §38-73-1100). Excess profits laws do not apply to property insurance due to its volatility, i.e., a major catastrophe can easily wipe out decades of profit as occurred in Louisiana and Mississippi 2005 as a result of Hurricane Katrina.

TYPES OF INSURERS

Admitted. Insurers that are licensed to transact the business of insurance in South Carolina are referred to as "admitted" or "voluntary" insurers. These insurers are subject to varying degrees of regulation of their rates, underwriting rules and policy forms, as set forth in the South Carolina Insurance Code. Companies such as Farm Bureau, Travelers, State Farm, Allstate and Nationwide are examples of well-known admitted insurers that write multiple lines of insurance in South Carolina. Admitted insurers write the majority of personal lines (non-commercial) policies. Admitted insurers are members of the South Carolina Property & Casualty Insurance Guaranty Association ("the Guaranty Fund").[6] Guranty funds are created by statute in most states to guarantee the claim payments of insolvent admitted insurers. Guaranty funds are paid for by assessments on other, solvent insurers. Admitted insurers are also members of the Wind Pool and are subject to assessment for losses of the Wind Pool.[7]

Surplus Lines. When admitted insurers are unable or unwilling to write a particular class of business, surplus lines insurers may be available to provide a market. Surplus lines insurers are sometimes referred to as "non-admitted" because they are not "licensed" by the Department; rather, they are "approved."[8] By statute, the Department has no authority to regulate the rates, underwriting rules or policy forms of surplus lines insurers; however, they are subject to some, but not all, provisions of the Insurance Code. Traditionally, surplus lines insurers have filled a special niche by insuring unusual, dangerous or very high value risks for sophisticated insureds that admitted insurers were not comfortable with, such as art collections, power plants, and the like. Surplus lines policies are not protected by the Guaranty Fund and surplus lines insurers are not subject to assessment by the Guaranty Fund. Surplus lines insurers also are not members of the

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[6] S.C. Code Ann. §38-31-10.

[7] S.C. Code Ann. §38-75-310, *et seq.* *See* further discussion on page 13.

[8] While surplus lines insurers must secure approval from the Department before doing business in South Carolina, they do not have to get approval for their rates or policy forms. Surplus lines insurance can only be procured by specially licensed insurance producers, called "surplus lines brokers," that have been licensed by the Department for this type of business. Essentially, surplus lines insurers are regulated through licensed surplus lines brokers. Surplus lines insurers must meet specific capital, financial and other standards in order to become an eligible surplus lines insurer in South Carolina.

Wind Pool and are not subject to assessment for Wind Pool losses, but the Wind Pool writes policies for insureds of surplus lines policies.

Many coastal property risks (i.e., high-valued properties) have long been insured by surplus lines insurers, but the typical homeowner policy was not written in the surplus lines market. However, in recent years, surplus lines companies have stepped in to fill an availability gap in the admitted market. Increasingly, homeowners in the coastal regions of this state must access the surplus lines market to secure insurance coverage for their properties. While surplus lines carriers have provided a much needed safety net, excessive reliance on that market for a large segment of otherwise traditional business, particularly consumer-oriented, personal lines coverage, is not a good long-term solution.

Residual Market. Residual market mechanisms are created by states to assure the availability of essential insurance coverage. Most states have residual market mechanisms for automobile, coastal or urban property, workers' compensation and medical malpractice insurance. Residual markets are necessary when the voluntary market is unwilling or unable to write all of the insurance needed by consumers. Residual markets are intended to supplement the private market, not to compete with nor displace it. Rates in the residual market are generally higher than the voluntary market, both because of the higher loss costs typically associated with residual markets and so as not to compete with the voluntary market. Residual markets are sometimes referred to as "involuntary" markets because they cannot refuse to write an eligible risk.

The South Carolina General Assembly authorized the creation of the South Carolina Wind and Hail Underwriting Association (the "Wind Pool") in 1971 to "provide a method whereby wind and hail insurance may be obtained more easily and equitably in the coastal areas of this State."[9] All admitted property and casualty companies licensed by the South Carolina Department of Insurance are members of and are required to participate in the Wind Pool. The Wind Pool provides wind and hail coverage in the "coastal area," which is statutorily defined as:

[9] S.C. Code Ann. §38-75-320.

> (a) all areas in Beaufort County and Colleton County which are east of the west bank of the intracoastal waterway;
> (b) the following areas in Georgetown County: all areas between the Harrell Siau Bridge and Murrells Inlet which are east of a line paralleling and lying one hundred fifty feet east of U.S. Highway No. 17 Business, all areas in Murrells Inlet which are east of U.S. Highway No. 17 Business, and Cedar Island, North Island, and South Island;
> (c) all areas in Horry County east of a line paralleling and lying one hundred fifty feet east of U. S. Highway No. 17 Business;
> (d) the following areas in Charleston County: Edingsville Beach, Kiawah Island, Botany Bay Island, Folly Island, Seabrook Island, Morris Island, and all areas north of the city of Charleston which are east of the west bank of the intracoastal waterway.[10]

Insurance companies writing policies in the defined territory may either offer wind coverage or exclude wind coverage (for a reduced premium). If an insurer excludes wind coverage, that coverage may be written by the Wind Pool (for an additional premium). As a result, the consumer will have a wind insurance policy with the Wind Pool and a separate insurance policy with a voluntary insurer for all other property perils. In the event of a hurricane, the Wind Pool will pay the losses covered under its policies. If those losses exceed the Wind Pool's funds, all admitted property insurance companies are assessed for the difference based on their market share in the state. Insurers recover these assessments by passing them back to consumers on a statewide basis through future rate filings.

[10] S.C. Code Ann. § 38-75-310.

FACTORS CONTRIBUTING TO PROPERTY INSURANCE AVAILABILITY ISSUES

The 2005 hurricane season was the busiest, deadliest and most costly in United States history, with 28 named storms, 15 of which were hurricanes. Total insurer losses from all 2005 catastrophes are estimated to be over $60 billion. Private insurer losses from Hurricane Katrina alone are estimated to be $40 billion. The risk of loss from hurricanes like Katrina and from other mega-catastrophes changed the insurance environment in all coastal states in the country, including South Carolina.

Although the 2004 and 2005 hurricane seasons were the tipping point for coastal property insurance market meltdown, South Carolina's coastal property insurance market has been deteriorating for several years, primarily due to weather, population growth and development, and other contributing factors such as catastrophe modeling, rating agencies, and reinsurance.

WEATHER

Hurricane History. Hurricanes are not new to South Carolina. Between 1900 and 2000, 14 major hurricanes affected South Carolina. Four of those hit South Carolina directly: the Sea Island Storm in 1893, Hurricane Hazel in 1954, Hurricane Grace in 1959 and Hurricane Hugo in 1989.

Table 1.1: Major Hurricanes to Hit South Carolina

YEAR	NAME	CATEGORY	FATALITIES IN S.C.	ESTIMATED S.C. PROPERTY LOSSES IN 2005 DOLLARS
1854	Unnamed	3	Unknown	unknown
1885	Unnamed	3	Unknown	unknown
1893	Sea Island Hurricane	3	1000 - 2000	$10 Million
1906	Unnamed	3	0	unknown
1940	Georgia / SC Hurricane	1	60	$1.5 Million
1954	Hazel	4	95	$100 Million
1959	Gracie	3	7	$20 Million
1986	Hugo	4	20	$7 Billion

In the past eight years South Carolina has incurred significant property losses from four of the top ten most costly hurricanes in United States history: Hugo, Charley, Frances and Jeanne. Additionally, South Carolina incurred significant property losses from remnants of Hurricanes Dennis, Klaus, Bonnie, Gaston, Floyd and Fran. In 1989, Hurricane Hugo made landfall at Bull's Bay just northeast of Charleston/Sullivan's Island, South Carolina. Hugo remains the worst natural disaster in South Carolina's recent history in terms of property loss.

Table 1.2: The Ten Most Costly Hurricanes in the United States

			Estimated insured loss (000 omitted)	
Rank	Date	Hurricane	Dollars when occurred	In 2005 dollars
1	Aug. 25-29, 2005	Katrina	$40,600	$40,600
2	Aug. 23-24, 25-26, 1992	Andrew	15,500	21,576
3	Oct. 24, 2005	Wilma	10,300	10,300
4	Aug. 13-15, 2004	Charley	7,475	7,728
5	Sep. 16-21, 2004	Ivan	7,110	7,351
6	Sep. 17-18, 21-22, 1989	Hugo	4,195	6,607
7	Sep. 20-26, 2005	Rita	5,000	5,000
8	Sep. 5, 2004	Frances	4,595	4,751
9	Sep. 15-25, 2004	Jeanne	3,440	3,557
10	Sep. 21-28, 1998	Georges	2,900	3,475

Weather Forecasts. Weather experts believe that we are in the midst of a prolonged period of increased frequency and severity of tropical activity in the Gulf and Atlantic regions that will last another 15-20 years.[11] Hurricanes that strike South Carolina typically originate in the Atlantic, and meteorologists believe that the frequency and severity of hurricanes in the Atlantic Basin are cyclic. According to experts, hurricane frequency and severity was above average for a period of 20-30 years starting in the

[11] Phillip J. Klotzbach and William M. Gray, "Causes of the Unusually Destructive 2004 Atlantic Basin Hurricane Season," *American Meteorological Society*, October 2006, pp. 1331-1332.

1930s, followed by a 20-30 year period of below average activity from the mid 1960s to the mid 1990s. In 1995, the Atlantic Basin began another 20-30 year period of above average hurricane activity. “Above average” does not mean that there will be severe hurricanes every year or in all regions, but, for that period, the average activity will be greater than the previous 15 to 20 years.[12]

POPULATION GROWTH AND DEVELOPMENT

Population Growth. In 2005, the United States Department of Commerce Census Bureau reported that 55% of the United States population lived within 50 miles of the coast. It is predicted that coastal population will increase by seven million between 2003 and 2008 and by an additional five million between 2008 and 2015.[13] South Carolina has experienced similar growth in population and development. Between 1980 and 2003, the coastal population in South Carolina increased 33%.[14] As shown in Table 2.1, South Carolina ranks tenth in coastal population growth in the United States. Approximately 1.7 million people now live in the coastal area of South Carolina. The concentration of property in a high-risk area dictates the potential severity of damage: the greater the concentration of property in hurricane-prone coastal areas, the greater the potential damage and the greater the risk for insurers.

[12] *Ibid* .
[13] Kristen M. Crossett *et al*., “Population Trends Along the Coastal United States: 1980-2008,” National Oceanic and Atmospheric Administration, September 2004, p. 38.
[14] Insurance Information Institute, “Hurricanes,” http://www.iii.org/media/facts/statsbyissue/hurricanes/.

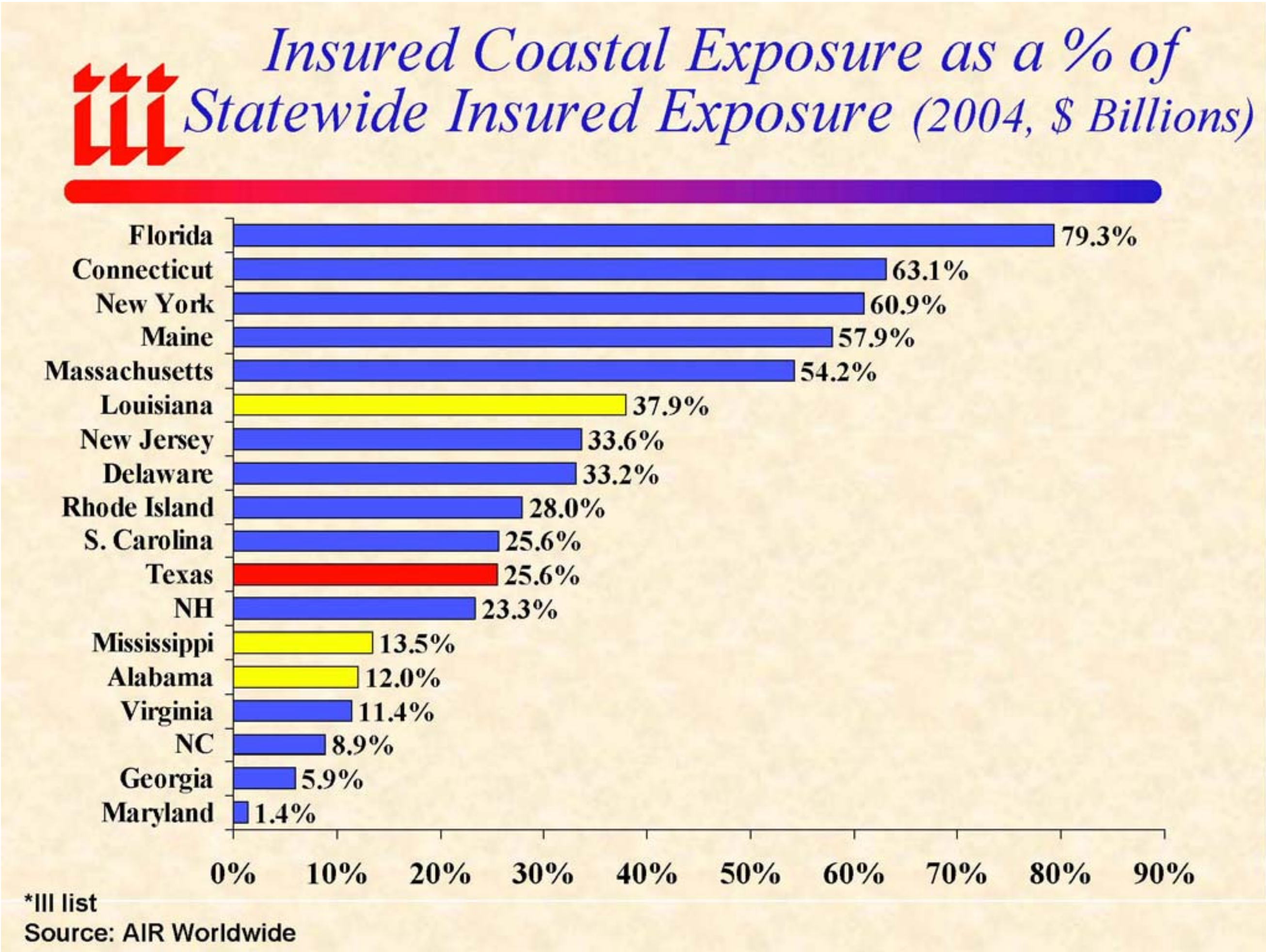
Table 2.1: Leading States in Coastal Population Growth, 1980-2003

Rank	State	Percent change
1	Florida	75%
2	Alaska	63
3	Washington	54
4	Texas	52
5	Virginia	48
6	California	47
7	New Hampshire	46
8	Delaware	38
9	Georgia	35
10	South Carolina	33

Increased Property Value and Increased Construction Costs. As coastal population increases, so do the number and value of exposed properties. Nationally, the value of properties located in coastal areas has increased dramatically. Applied Insurance Research ("AIR") estimates that the value of properties in coastal areas of the United States has doubled over the last decade. South Carolina has experienced an extraordinary increase in the number of new residential and commercial structures along the coast and in the value of property along the coast. As shown in Table 2.2, total insured property value for the state of South Carolina in 2004 was $581 billion of which $148.8 billion, or 26%, was located in hurricane prone areas – a much higher percentage than neighboring North Carolina and Georgia at 8.9% and 5.9%, respectively. Since 1988, South Carolina's coastal insured property value has increased 377%.[15]

[15] AIR Worldwide Corporation, "The Coastline at Risk: Estimated Insured Value of Coastal Properties," Boston, Mass., September 21, 2006, p.1.

Table 2.2: Insured Property Values



ADDITIONAL CONTRIBUTING FACTORS

Catastrophe Models. Catastrophe models are based on historical storm data and other weather information to predict the likelihood, frequency and severity of tropical activity in each of the coastal regions. Additionally, based upon an individual insurer's book of business, catastrophe models estimate the amount of damage and losses that will be insured by that insurer in the event of a storm. Insurers and reinsurers rely heavily upon catastrophe models in determining how much coastal property insurance business they write, where they write and the rates they charge.

There are three commercial vendors of catastrophe modeling software programs: Risk Management Solutions ("RMS"), Applied Insurance Research ("AIR"), and EQECAT ("EQE"). Following the 2004 and 2005 hurricane seasons, catastrophe modelers revised their models as a result of new data from those storms and evidence that we have entered an era of increased hurricane frequency and severity. Modeled losses are estimated to increase by 25-40% on average.[16] Coastal property insurance premiums reflect the increased risk indicated by the models.

Rating Agencies. Rating agencies rate the financial strength of insurers. Ratings are important to both consumers and insurers. Consumers benefit from these ratings because they are assured that their claims will be paid. Additionally, insurers with better ratings receive better credit terms than insurers with lower ratings. Insurers with lower ratings pay more for capital, which is reflected in higher premiums charged to consumers.

Based on the current weather predictions and catastrophe model estimates, rating agencies have increased the capital requirements for insurers writing coastal property insurance, which has had a negative impact on insurer capacity. Prior to 2005, insurers generally were required by rating agencies to have sufficient capital to pay claims associated with one 100-year storm (one that occurs, on average, every 100 years). After 2005 and the realization that multiple major hurricanes could strike the same or nearby areas, rating agencies doubled their capital requirements. Insurers responded by infusing additional capital (if possible and at a significant cost), reducing their exposure in coastal areas, purchasing additional reinsurance, or some combination of these actions.

Reinsurance. Reinsurance is insurance for insurance companies and is a way for insurance companies to further spread their risk, or to hedge their bets against loss. Insurers "cede" or transfer a portion of their risk and pay a portion of the premium they receive from the policyholder to reinsurers. In the event of loss, the insurer will handle and pay claims and then be reimbursed by the reinsurer according to the terms of the

[16] NAPCO LLC, "The Impact of Changes to the RMS U.S. Hurricane Catastrophe Model," http://www.napcollc.com/articles/JuneReviewRMSHurricane.pdf.

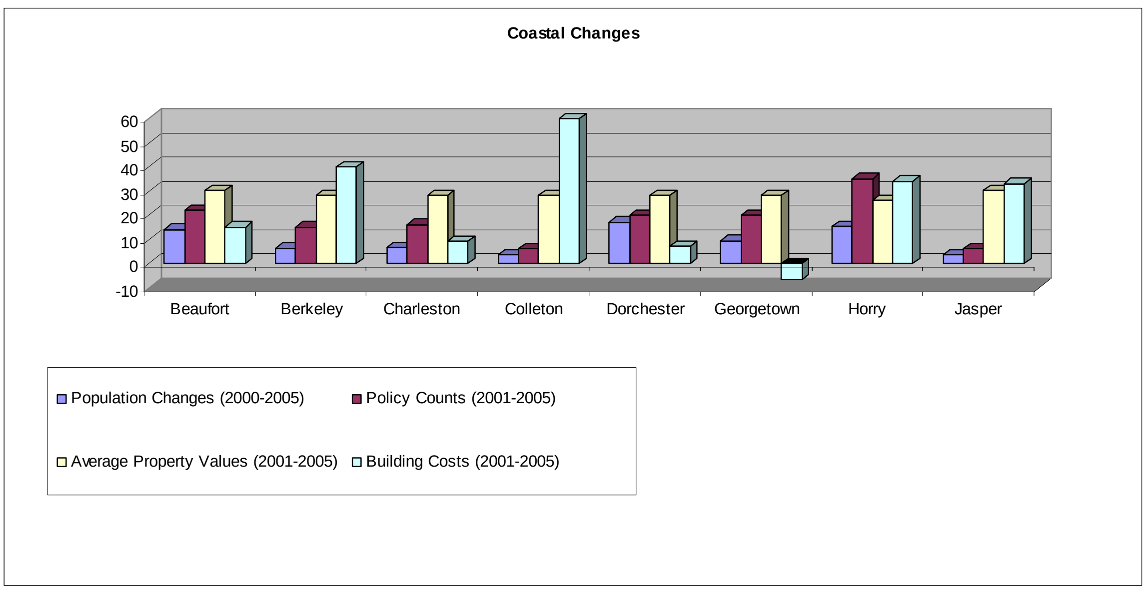
reinsurance agreement. As a result of rating agency actions, insurers have sought to purchase additional reinsurance. Reinsurers, which are subject to the same rating agency actions, cannot write as much business as before and/or they must charge higher premiums to insurers because of the increased demand for their product. Just as rating agencies were requiring insurers to purchase more reinsurance, they were requiring reinsurers to sell less at a higher price. These increased reinsurance costs are passed on to consumers. Nationwide, reinsurance costs have gone up an average of 30%. In the coastal areas, however, the premiums paid by insurers to reinsurers have increased 100% to 300%.

COASTAL PROPERTY MARKET CONDITIONS

VOLUNTARY MARKET

Capacity and Availability. Both admitted and surplus lines insurers report significant constraints on their capacity, which have caused reduced availability. Statistics show that the demand for coastal property insurance has increased more than the supply of insurers writing that insurance, which leads to limited availability and higher prices. In South Carolina's coastal counties, the number of policies written by admitted insurers has only increased 3%, while population has grown 9%, building permit activity has increased 27%, and property values have increased 28% since 2000.

Table 3.1: Coastal Changes

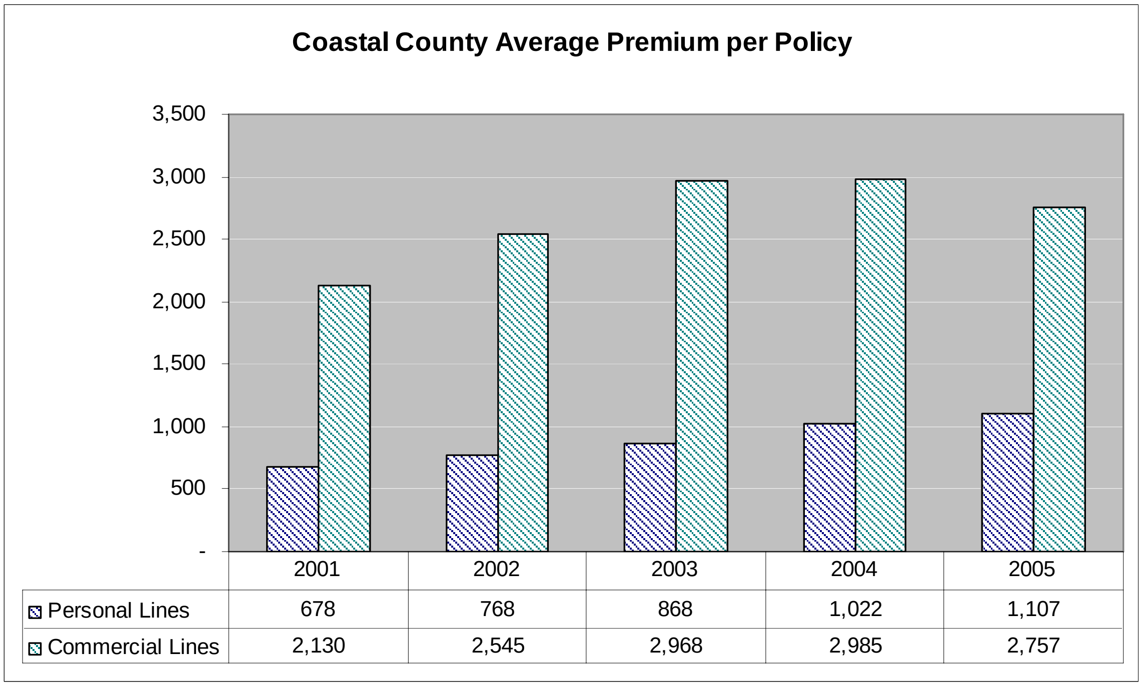


Affordability. In addition to increased demand for coastal property insurance (due to population growth and development) and decreasing supply (due to weather, catastrophe models, rating agencies, and reinsurance), increasing property values have contributed to rising insurance premiums in both the admitted and the surplus lines market.[17] As shown

[17] It is a fundamental law of economics that when demand exceeds supply, prices go up. Additionally, since homeowners insurance is intended to cover the cost of rebuilding, premiums are based on property values.

in Table 3.2, the average premium for coastal property insurance increased 63% for personal lines and 29% for commercial lines from 2001 to 2005.

Table 3.2: Average Premium per Policy for Admitted Insurers



	2001	2002	2003	2004	2005
Personal Lines	678	768	868	1,022	1,107
Commercial Lines	2,130	2,545	2,968	2,985	2,757

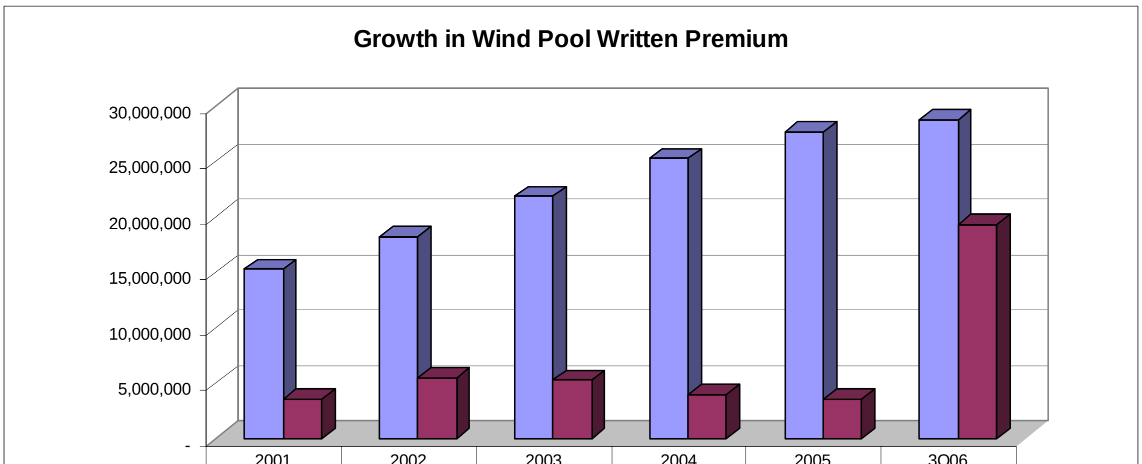
Comparable data is not available for the surplus lines market, but increases of as much as 700% for condominium association policies have been reported in the media.[18] Very few admitted carriers are writing condominium association policies. Most of these policies are written by the surplus lines market so the Department has had no authority to approve or disapprove these increases.[19] Even at such high rates, few insurers are willing to write many of these risks. This unwillingness to write "at any price" is not consistent with traditional economic theory that high prices attract additional suppliers.

[18] Jenny Burns, "Lawmaker Airs Plans to Lower Insurance," *Myrtle Beach Sun News*, October 18, 2006.
[19] The largest increase approved by the Department for standard homeowners policies in the last 12 months has been an overall average of 12.4% statewide with 3.1% of policyholders receiving increases of 50 - 65% in some coastal areas. While these admitted insurer rate increases have been less than surplus lines insurers, admitted carriers are not selling many policies and the Department has no authority to require them to do so.

RESIDUAL MARKET

Capacity. Unlike voluntary insurers, residual market mechanisms do not retain capital and are not subject to restrictions on capacity, such as financial ratings. In theory, residual markets have unlimited capacity. The Wind Pool's "unlimited capacity" is illustrated in Table 4.1, which shows the considerable growth of the Wind Pool. From 2001 through the third quarter of 2006, the written premiums for the Wind Pool increased 88% for residential lines and 448% for commercial lines.

Table 4.1: Written Premium for the Wind Pool (2001-2006)

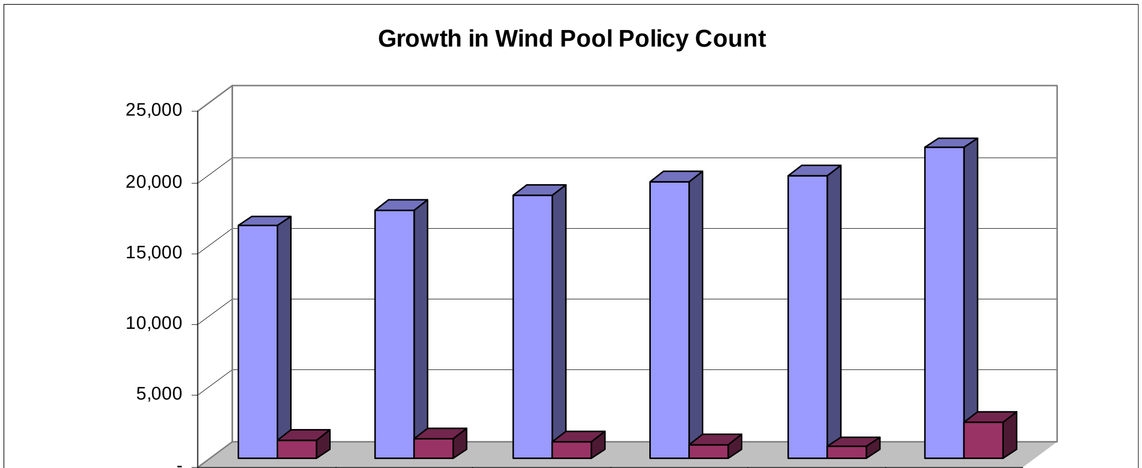


	2001	2002	2003	2004	2005	3Q06
Residential	15,303,000	18,250,000	21,843,000	25,277,000	27,687,000	28,810,000
Commercial	3,531,000	5,493,000	5,271,000	3,913,000	3,560,000	19,343,000

Availability. Like capacity, there is no limit, in theory, on the number of policies a residual market mechanism can write. These mechanisms exist solely to assure the availability of essential property insurance coverage.

Because fewer and fewer insurers are writing wind coverage for properties located within the Wind Pool territory, the Wind Pool is writing more and more policies. Through the third quarter of 2006, the number of commercial policies written by the Wind Pool skyrocketed over prior years, indicating that the admitted market had reached its capacity, particularly for commercial dwelling policies, including condominiums.[20]

Table 4.2: Policy Count for the Wind Pool (2001-2006)



	2001	2002	2003	2004	2005	3Q06
Residential	16,430	17,560	18,570	19,550	19,990	21,920
Commercial	1,360	1,437	1,200	986	850	2,605

While in theory a residual market mechanism has unlimited capacity and availability, in reality a large, growing residual market indicates the presence of fundamental problems within the voluntary insurance market. Residual market mechanisms do not usually retain any surplus; therefore, they have few resources to draw upon to cover a deficit. Residual market mechanisms may purchase reinsurance, but the cost is very high and most residual market mechanisms do not purchase substantial reinsurance.[21] For these reasons, deficits are covered through assessments on the member insurance companies.[22] Consequently, insurance companies are reluctant to write in states with large residual markets due to the

[20] In October 2006, the Wind Pool reported a decrease in the number of condominium policies it was writing, indicating additional availability in the voluntary market. A comparable decline in homeowners policies was not reported.
[21] The South Carolina Wind and Hail Underwriting Association is fairly unique in that it attempts to purchase reinsurance to a 1-in-100 year storm level.
[22] The assessment method works relatively well for residual market mechanisms as long as 1) residual market rates are adequate, i.e., not suppressed below needed levels, and 2) there is minimal or no exposure to catastrophic losses.

risk of large assessments.[23] As the Wind Pool grows, insurers may become more reluctant to write coverage in South Carolina due to the risk of large assessments.[24]

Affordability. As stated earlier, residual market mechanisms were created to guarantee the availability of certain types of insurance coverage. They were not created to replace or compete with the voluntary market. Rather, they function as a market of "last resort" for those consumers who have difficulty obtaining insurance coverage in the voluntary market. As the market of last resort, the Wind Pool is not intended to have low rates.

The Wind Pool is subject to the same rate approval process and regulation as the voluntary market, i.e., rates may not be inadequate, excessive or unfairly discriminatory. Based on the most recent models issued by AIR and RMS in June 2006, the rates charged by the Wind Pool for dwelling coverage appear to be inadequate. Inadequate Wind Pool rates increase the likelihood of an assessment in the event of a loss. Assessments on insurers are ultimately passed on to policyholders as a part of the premium.

The average Wind Pool premium (total price for all units of insurance) increased 49% for personal lines and 61% for commercial lines from 2001 to 2005. (See Table 4.3).
However, the actual rate per unit for coverage offered by the Wind Pool only increased 16.7% during this same period. [25]

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[23] After Katrina, the Mississippi Windstorm Underwriting Association assessed its member insurers a total of $545 million. As a result, insurers are refusing to write or limiting their writings because more policies translate into larger assessments. Laura Hipp, "Recovering Mississippi Businesses Face Hefty Commercial Insurance Hikes," *Insurance Journal*, November 28, 2006, http://www.insurancejournal.com/news/southeast/2006/11/28/74610.htm.

[24] As more policies are written in the surplus lines market which is not subject to Wind Pool assessment, admitted insurers' market share increases as does the size of their potential assessment.

[25] Rates are not the same as premiums. A rate is the price for each unit of insurance — $2.50 per $1,000 of property insurance, for example. The premium represents the total cost, which reflects increased property values. If the price to rebuild a house is $150,000, the premium would be 150 x $2.50.

Table 4.3: Average Premium per Policy for the Wind Pool (2001-2005)

	2001	2002	2003	2004	2005
Residential	931	1,039	1,176	1,293	1,385
Commercial	2,596	3,823	4,393	3,969	4,188

OVERVIEW OF PREVIOUS INITIATIVES

The South Carolina General Assembly and the Department have undertaken a number of initiatives and have formulated various policies in the past decade in an effort to maintain a viable coastal property insurance market. Historically, these efforts have focused on promoting a competitive market as the best long-term solution to insurance availability and attendant affordability issues. Loss mitigation has also been an important component in South Carolina's approach to coastal property issues. The following sections describe previous initiatives.

COASTAL PROPERTY INSURANCE TASK FORCE

In 1999, the Department organized an *ad hoc* task force to monitor coastal property insurance market conditions and to brainstorm regulatory, legislative and private sector initiatives to address developing problems. The task force consisted of producer and insurer representatives of the property and casualty insurance industry, the Office of the South Carolina Consumer Advocate, members of the Department, and other interested parties. The task force considered a number of options for improving insurance availability and affordability in the coastal area, including expansion and other changes to the Wind Pool, creation of a hurricane plan, recruiting more insurers to the state, allowing insurers to use catastrophe modeling in rate filings, capping hurricane deductibles, and creation of a Florida-style state-run citizens' insurance plan. Many of the ideas of the task force were incorporated in the Property and Casualty Personal Lines Modernization Act of 2004; others were not deemed appropriate at the time.

PROPERTY AND CASUALTY INSURANCE PERSONAL LINES MODERNIZATION ACT

Flex Rating. In 2004 the legislature passed the Property and Casualty Personal Lines Insurance Modernization Act ("the Act"). Among other things, the Act streamlined the rate approval process in order to attract more insurers to the state.[26] Specifically, the Act implemented a flex-rating system for property insurance coverage in South Carolina. Similar legislation adopted in 1999 to address problems within the automobile insurance industry was successful in attracting over 100 new insurance companies to the state and transforming the South Carolina automobile insurance market from one of the worst in the country to one of the most competitive.

Although insurers praise the flex-band approach for homeowners filings, the hurricane seasons of 2004 and 2005 caused many new companies to delay entering South Carolina. Many companies had to recapitalize, further impeding their ability to enter new markets, including South Carolina, despite the favorable regulatory environment.

Catastrophe Models. The Act also allowed the Department to evaluate catastrophe models used in property rate filings.[27] Although no funding was provided by the Act for the performance of this highly technical and complex analysis, a panel of experts retained by the Department reviewed filings submitted by modeling firms AIR and EQE in the summer of 2005. The Department has not yet accepted either vendor's catastrophe model for general use, but insurers are being allowed to continue using the models for certain aspects of their underwriting and rating after review and approval by the Department.

[26] Homeowners' rate filings for +/-7% increases or decreases are no longer subject to prior approval, and insurers may begin using rates within 30 days of filing unless disapproved by the Department prior to that date. The new filing procedure does not preclude a thorough review of rate modification requests; however, it does offer a simplified process, thereby reducing the time it takes an insurer to get its products to market.

[27] South Carolina law has given the Department the authority to consider computer simulated models such as catastrophe models in rate filings since 1996. See S.C. Code Ann. § 38-73-1095 (2002). Despite that authority, the use of catastrophe models in ratemaking has been questioned even though it is an accepted industry-wide practice. *See, e.g., State Farm and Casualty Company v. South Carolina Department of Insurance,* Docket No. 03-ALJ-09-0210-CC, S.C. Administrative Law Court., November 17, 2003. The Property and Casualty Insurance Personal Lines Modernization Act ("the Act") further clarified the authority of the Department to permit the use of catastrophe models and authorized the Department to assemble the experts needed to evaluate these tools. *See* S.C. Code Ann. § 38-73-1140 (Supp. 2005).

Because insurers and reinsurers rely heavily upon catastrophe models in determining how much coastal business they write, where they write and the rates they charge, it is important that the Department be able to determine that the catastrophe models utilize South Carolina-specific data and that insurers apply the models appropriately.

Wind Pool. While some members of the task force strongly supported expansion of the Wind Pool territory, others did not. Rather than changing the statutory definition of the Wind Pool territory, the Act contained compromise language allowing the Director to temporarily expand the Wind Pool territory "because of the unavailability of coastal property insurance . . . on a reasonable basis through normal channels."[28] The statute expressly limits the Director's authority to "availability" and does not define the phrase "on a reasonable basis through normal channels."[29]

ALTERNATIVE RISK TRANSFER MECHANISMS

Typically, insurers purchase reinsurance to help manage their risk of exposure to a catastrophic event. After a catastrophic loss, reinsurance capacity may be diminished and reinsurers might raise prices or limit availability of future catastrophic reinsurance coverage. Recognizing the impact of catastrophe exposure on the insurance industry, new capital market instruments were developed as an alternative to reinsurance.

South Carolina has been a frontrunner in enacting legislation that gives insurers in South Carolina additional options for arranging and managing their capital and risk. Regulators believed that insurance companies would utilize these alternative mechanisms to raise more capital to safeguard against catastrophic loss.

[28] S.C. Code Ann. § 38-75-460.

[29] In the late summer and early fall of 2006, many agents, consumers and other interested parties called for expansion of the Wind Pool. The Department's research revealed that coverage was technically available, albeit very expensive, thus not meeting the statutory threshold for expansion under the Director's limited emergency powers.

Captives. In June 2000, South Carolina legislature enacted Act No. 331, which established South Carolina as a captive domicile.[30] Upon passage of Act No. 331, South Carolina entered a market long dominated by offshore markets in the Cayman Islands, Bermuda, and Ireland. Within a year of enactment, South Carolina was viewed as one of the three most important U.S. captive domiciles, led only by Vermont and Hawaii, which enacted captive laws in 1981 and 1987, respectively.

Captive insurers are entities created to insure the risk of their owners, usually the parent company and its affiliates, as an alternative to the insurance coverage provided by traditional commercial insurance industry. Thus, captive insurance is a formal program of self-insurance, as opposed to mere self-funding of losses. Captives provide commercial, economic and tax advantages to their owners due to the reductions in costs, the ease of risk management and the flexibility for cash flows they generate. Additionally, they may provide coverage that is neither available nor offered in the traditional insurance market at reasonable prices. It was hoped that the captive mechanism would provide a vehicle for innovation in the coastal property insurance market but that has not been the case due to many of the same underlying cost drivers that are affecting traditional insurers.

BUILDING CODES

In 1997, the South Carolina General Assembly passed legislation establishing a statewide building code that includes the education and certification of building code inspectors and officials, an advisory committee to the Director of Insurance and to the South Carolina Building Codes Council, and a loss mitigation grant fund. Additionally, the legislation established a Loss Mitigation Grant Program within the Department. The Program assists local governments with the implementation and enforcement of the statewide building code and the development and implementation of strategies for dealing with catastrophes. South Carolina is second only to Florida in the number of building inspectors and is the only state other than Florida that requires continuing education for building inspectors. Strong building codes and enforcement of those codes are major

[30] S.C. Code Ann. § 38-90-10 *et seq.* Title 38 was subsequently amended to provide for other alternative risk transfer mechanisms, including special purpose financial vehicles and securitization of risk. *See* § 38-10-10 *et seq.* ,§. 38-14-20 *et seq.*

factors in insurers' underwriting and pricing of homeowners policies. South Carolina is the only state with an insurance company representative on the Building Codes Council.

LOSS MITIGATION

Mitigation is the ongoing effort to lessen the impact of disasters on people's lives and property through damage prevention. Over the years, the Department has sponsored a number of events aimed at loss mitigation and consumer education.

Hurricane Expos. Between 1999 and 2001, the Department partnered with Home Depot and local radio and television stations to host one-day events at various Home Depot locations along the South Carolina coast. These events included presentations and information about hazard mitigation, flood mitigation, building codes and emergency preparedness. The events educated the public on the importance of preparing homes against hurricanes and other natural disasters. These events were free and open to the public and included contests and prizes. The Department has not been able to fund these activities in recent years.

CE Day. In June 2006, the Department and the Independent Insurance Agents and Brokers of South Carolina hosted a continuing education seminar for agents entitled *Plan, Prepare and Protect - An Agency Survival Guide Against Natural Disasters*. More than 100 people attended the day-long event. Presentations included overviews of the South Carolina Wind and Hail Underwriting Association, the National Flood Insurance Program, and the Federal Alliance for Safe Homes. Also, a climatologist from the University of South Carolina made a presentation about South Carolina's hurricane exposure. The Department plans to present this program to coastal counties in the Spring of 2007.

THE PROPERTY INSURANCE FORUM

In June 2005, the Department hosted a Property Insurance Forum in Charleston to recruit insurance companies to our state. More than 125 people representing 107 insurers and insurance agencies attended the forum. Both the Governor and Lieutenant Governor addressed the attendees. The forum highlighted the favorable business, legal and regulatory environment in South Carolina. Since the forum, Director Eleanor Kitzman has personally met with numerous insurers that expressed an interest in doing business in South Carolina. Several insurers have entered the state recently (both admitted and surplus lines), but this new capacity is not sufficient to meet the state's coastal property insurance needs.[31]

[31] Some of this new capacity was used to take over the canceled policies of Florida Select Insurance Company, a sizeable coastal property insurer that became insolvent when it was unable to obtain adequate reinsurance.

OPTIONS FOR CONSIDERATION

Hurricanes in South Carolina are inevitable, even if there is disagreement as to how many there will be and when and where they will strike. There can be no disagreement, however, as to the economic devastation that will be caused by a major hurricane. The only remaining issue is who will bear the cost of this risk of loss.

The goal of any legislative or regulatory action should be to provide a comprehensive approach to a complex problem while balancing the interests of the consumer and the need for the state to maintain a viable, competitive coastal property insurance market. Highlighted below are a number of options for consideration. The options range from relatively minor modifications of existing statutes to major system reform. These options are presented for information and consideration and are not necessarily recommended by the Department.

1. Loss Mitigation. Loss mitigation should be at the forefront of any coastal property insurance solution. If the state of South Carolina does not require storm resistant housing, the insurance industry cannot be expected to insure it. Achieving comprehensive loss mitigation is a long-term goal that can reduce South Carolina's loss exposure by as much as 60% and can also produce nearer-term relief. Evidence shows that safe homes can be built without prohibitively higher costs, especially when cost is calculated in terms of loss of quality of life post-hurricane, the payment of insurance deductibles, and general societal costs. According to a 2005 report by the Multi-hazard Mitigation Council of the National Institute of Building Sciences, each dollar spent on mitigation saves society an average of four dollars. The necessary components of an effective loss mitigation plan include:

a. Meaningful land use planning which recognizes that some areas may not be suitable for development for a variety of reasons (health, environmental, etc.) and are uninsurable in the private market.

b. Adoption and enforcement of stronger building codes (Code Plus) in coastal areas.

c. Creation of a standardized wind resistance rating system and building inspection process for all coastal structures, similar to the My Safe Florida Home program enacted in Florida in 2006. In Florida, all homesteaded property will be eligible for free home inspections to determine what mitigation measures are needed to reduce vulnerability to hurricane damage. Home inspections include a rating scale specifying the current and projected wind resistance rating.

d. Identification of approved retrofits to improve storm resistance and enhancement of the building inspection process to include such retrofits. Additional training will be needed for building inspectors (and contractors) to ensure proper installation of approved retrofits.

e. Incentives for retrofitting existing homes, such as sales tax rebates, tax credits or grant funds. (The Florida legislature appropriated $250M for matching grants of up to $5,000. Low income residents are not required to match and homes over $500,000 in value or secondary residences are not eligible.)

2. Wind Pool Reform. The Wind Pool is an effective mechanism for dealing with the primary peril of a hurricane, which is wind.[32] However, changes to Section 38-75-310, *et seq* are necessary to better address the current market environment, including:

a. Clarify the Wind Pool's status as a market of last resort.

b. Redefine the Wind Pool territory to east of the west bank of the Intracoastal Waterway in the seacoast area. The current Wind Pool territory has not been changed since 1990 and is inadequate in light of changes in population and development.

c. Give the Director greater authority to make changes to the Wind Pool territory, rates and operations in the event of an emergency due to dislocation in the market for essential property insurance in the seacoast area. The current statutory language is insufficient to meet the needs of the current market environment as the Director's emergency authority is expressly limited to unavailability.

d. Restructure the Wind Pool so as to qualify for tax-exempt status and begin accumulating catastrophe reserves as opposed to relinquishing all of its premiums to reinsurers year after year, with no residual benefit. Florida, Louisiana and Texas have tax-exempt residual markets.[33]

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[32] Flood is the other major peril, but is excluded from all homeowners' policies and is covered by the National Flood Insurance Program.

[33] The South Carolina Medical Malpractice Joint Underwriting Authority, Section 38-79-260. South Carolina Associated Auto Insurers plan are tax exempt.

e. Require that the Wind Pool rates be reviewed quarterly to ensure that they are actuarially sound and self-sustaining in order to fund adequate reinsurance purchases and avoid the potential for assessments that are passed back to policyholders statewide and deter insurers from doing business in the state. Assessments on insurers should be recouped as a direct pass-through to policyholders as opposed to the current method in which an insurer's assessments must be included as part of it's regular rate filing process, are not shown separately from the premium and are more likely to be spread on a statewide basis.

3. Insurance Cooperative. Under a self-insurance pool or cooperative, coastal residents would "pool" their hurricane risk and premium.[34] Premiums would be based on each property owner's historical loss history as opposed to the catastrophe models used by insurers and reinsurers. The self-insured pool would have lower expenses than commercial insurers because there would be no profit component, and these savings would be passed on to members of the pool. A self-insured pool could also reduce its expenses even further if it did not purchase reinsurance. Claims would be paid from the self-insured pool's funds, presumably premiums and investment income. If those funds were insufficient to pay all claims, there would be no guaranty fund protection. Members of the pool would have to decide whether to make only partial claim payments or to assess policyholders to make up the deficit.[35]

4. Creation of a State Hurricane Catastrophe Reinsurance Fund.[36] As a result of unprecedented levels of catastrophic insured losses in recent years, numerous insurers have determined that it is necessary for them to reduce their exposure to hurricane losses in order to protect their solvency. Moreover, world reinsurance capacity has significantly contracted, increasing the pressure on insurers to further reduce their catastrophic exposure. In 2006, the private sector insurance and reinsurance markets demonstrated

[34] There is no statutory framework in South Carolina for a mechanism of this type, for any line of insurance. While captives are a form of self-insurance, they are licensed as insurance companies and must meet certain financial solvency standards. Additionally, this type of self-insurance pool would not meet other requirements of South Carolina's captive insurance laws.

[35] Depending upon the structure of the self-insured pool and the obligations of its members, the pool may be able to issue bonds to raise additional funds to pay claims.

[36] This option is submitted with the caveat that any assumption of potential liability by the state should take into consideration the same risk factors that are causing private insurers to avoid or limit coastal exposure.

their inability to maintain sufficient capacity to enable residents of South Carolina to reasonably obtain essential property insurance, thus endangering the economy, public health, safety and welfare of the state.

A state program to provide a stable and ongoing source of reinsurance to insurers for a portion of their catastrophic hurricane losses could create additional insurance capacity sufficient to ameliorate those dangers.[37] This program should be created as a tax-exempt entity and should charge "near-market" premiums, which are market rates reduced only by the effects of tax-exemption and amortization of costs over a more appropriate, longer period of time.[38] The program should provide reimbursement at a high attachment point, such as a Category 3 or 1-in-100 year storm, and reimbursement should be capped at an appropriate level to be determined based on actuarial projections and catastrophe modeling. This approach addresses insurers' fear of "the big one" that is difficult to predict and price, which has resulted in the current market volatililty. Insurers would continue to be responsible for wind losses below the attachment point, which are more predictable and manageable.[39]

The program could be funded by premiums paid by insurers and investment income, which will grow on a tax-exempt basis. The program could also be funded by other sources of revenue, such as premium taxes associated with coastal property insurance, fees on certain transactions in the coastal areas, etc. The risk to the state is that a large loss occurs early in the existence of the program before there are sufficient assets to reimburse all losses.[40] In that event, the state would have to use other state funds or issue catastrophe bonds to make up any deficit. Numerous methods of repayment could be employed, including assessment of property owners (in the coastal area only or statewide,

[37] The Florida Hurricane Catastrophe Fund ("FHCF") was created in 1993 and, while it was inadequately priced and has not prevented severe market dislocation, most insurers believe that conditions would have been much worse but for the FHCF.
[38] The risk of catastrophic loss is currently financed on an annual basis through the purchase of reinsurance although that risk will not occur annually but, rather, sometime over a 15-20 year period.
[39] Other proposals for a "hurricane plan" would provide first dollar coverage for all losses as a result of a named storm, thus ensuring the state's regular and long-term liability for hurricane losses.
[40] To minimize this risk, initial seed money could be provided from surplus state revenues, if available.

depending on the size of the deficit), increase in sales tax in the coastal area, assessment of other lines of insurance, etc.

4. Insurance Reforms. Additional disclosures and notifications by insurers would provide greater transparency and lead-time to consumers, such as:

a. Insurers should be required to offer loss mitigation discounts and to notify applicants and policyholders of available discounts.

b. Insurers should be required to offer policies without wind coverage outside of the Wind Pool territory for those property owners that wish to substantially reduce their premium by assuming the risk of loss.

c. Insurers should be required to offer policies for the amount of the mortgage only instead of the full value of the home and/or offer higher deductibles that accomplish the same objective. This could result in a substantially reduced premium for those property owners that wish to assume a larger portion of the risk of loss.

d. Insurers should be required to give 60 days notice of cancellation or non-renewal instead of the current 30 day notice provided for in Section 38-75-1160.

e. Insurers should be required to provide details of premium charges, including breakdown by peril (wind, fire, theft, liability, etc.), any assessments, premium taxes, and other identifiable components of the total premium.

Other "insurance" reforms that have been proposed include prohibiting insurers from "cherry-picking" by requiring that they write on a state-wide basis, not just in non-coastal areas, and requiring insurers to write property insurance if they write other lines of business in the state and write property insurance in other states. Both of these proposals are problematic due to issues of capitalization, expertise, etc., and could disrupt other insurance markets.

5. Federal Tax Laws. South Carolina's Congressional delegation should advocate for changes in Federal tax laws to allow insurers to build catastrophe reserves and to create catastrophe savings accounts. Current law taxes reserves other than for known losses as ordinary income, thus providing no incentive to insurers to invest policyholder premiums in catastrophe reserves. Funds that could otherwise go to catastrophe reserves are taxed as and distributed as profit, to the detriment of consumers.

Catastrophe savings accounts would allow consumers to set aside pre-tax dollars to pay for loss mitigation, hurricane deductibles or other catastrophe-related expenses.

6. Capital Incentives for Insurers. In order to attract new insurers to South Carolina's coastal property market, or to increase capacity among existing insurers, funding in the form of "surplus notes"[41] could be provided under specified conditions. The state of Florida implemented such a program in 2006 and will provide up to $25M to qualified insurers that commit to meeting a minimum writing ratio of net written premium to surplus of at least 2:1 for residential property, including wind, for the term of the surplus note. The note is repayable to the state at the 10-year Treasury Bond interest rate and the state is a preferred creditor in the event of insolvency, after costs of receivership and payment of policyholder claims.[42]

7. Catastrophe Modeling. Because they are so heavily relied upon by insurers, reinsurers and rating agencies, catastrophe models are the primary force behind the current market turmoil. While catastrophe modelers, reinsurers and rating agencies are beyond the jurisdiction of the Department of Insurance, funding should be provided to enable the Department to continue and enhance its efforts to ensure that insurers have provided appropriate inputs based upon their South Carolina books of business and that they are properly utilizing the models in their underwriting and rating.

8. Post-event Operations and Reporting. After a major storm, many consumers and businesses may not be able to comply with the usual terms and conditions of insurance policies. In order to provide security, stability and advance notice to policyholders and insurers in the event of the declaration of an emergency by the Governor in the event of a hurricane, emergency procedures related to claims reporting requirements, grace period for payment of premiums and performance of other duties by insureds and temporary postponement of cancellations and non-renewals should be

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[41] A surplus note is an unsecured subordinated debt obligation that allows insurers to increase their surplus without the usual accounting offset to assets. Qualifying surplus notes meet the requirements of the National Association of Insurance Commissioners Statement of Statutory Accounting Principals No. 41. *See* S.C. Code Ann. §38-90-420(22).

[42] Fla. Admin. Code Ann. 215.5595.

enacted in advance. The Director should also be given authority to issue other general orders applicable to insurance companies, entities or employees to protect the safety of consumers and the insurance marketplace. Any such orders would be for a specified period of time unless terminated sooner by the Director, but could be extended for one additional time period if the Director determines that the emergency conditions giving rise to the initial order still exist.

CONCLUSION

The market for coastal property insurance in South Carolina deteriorated rapidly in 2006 creating a volatile and unpredictable environment. When available, coastal property insurance is extremely limited and sporadic. Many insurers, both admitted and surplus lines, are reducing the number of policies and the level of coverage they write, increasing deductibles, and restricting the types of structures they are willing to insure, resulting in fewer policies being offered for sale relative to the number of policies needed by consumers. Clearly, there is an availability problem in the voluntary market. Consequently, coastal property owners must look to the Wind Pool, if they happen to reside within the outdated and inadequate Wind Pool territory. Otherwise, they are at the mercy of a volatile, opportunistic surplus lines market that was never intended to operate in this segment of the market. Moreover, rate increases of the magnitude seen in the last year are unaffordable for all but the wealthiest of individuals and, in many instances, constitute constructive unavailability.

In light of the forecasts of above-average hurricane frequency and severity for the next several years, insurers will continue to face financial pressures due to catastrophe exposure. As they attempt to manage their risk of exposure by 1) restricting underwriting, 2) increasing rates, or 3) both so that they may meet their policyholder obligations, i.e., pay claims, South Carolina's coastal property owners will continue to pay a high price, both literally and figuratively.

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